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Rainy Day Fund Best Practices

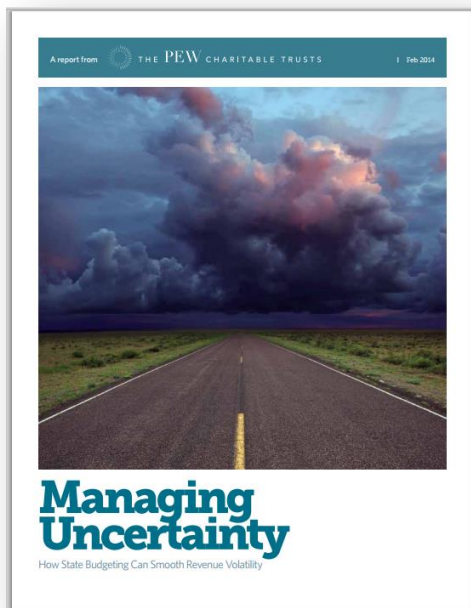
**Presentation to the
North Carolina Committee on Savings Reserve Account
by Robert Zahradnik, Director, States' Fiscal Health**

April 13, 2016

Research by Pew on Rainy Day Funds



Three Pew Reports to Date Have Identified Elements of Sound Rainy Day Fund Design



Causes and effects of volatility on state budgets



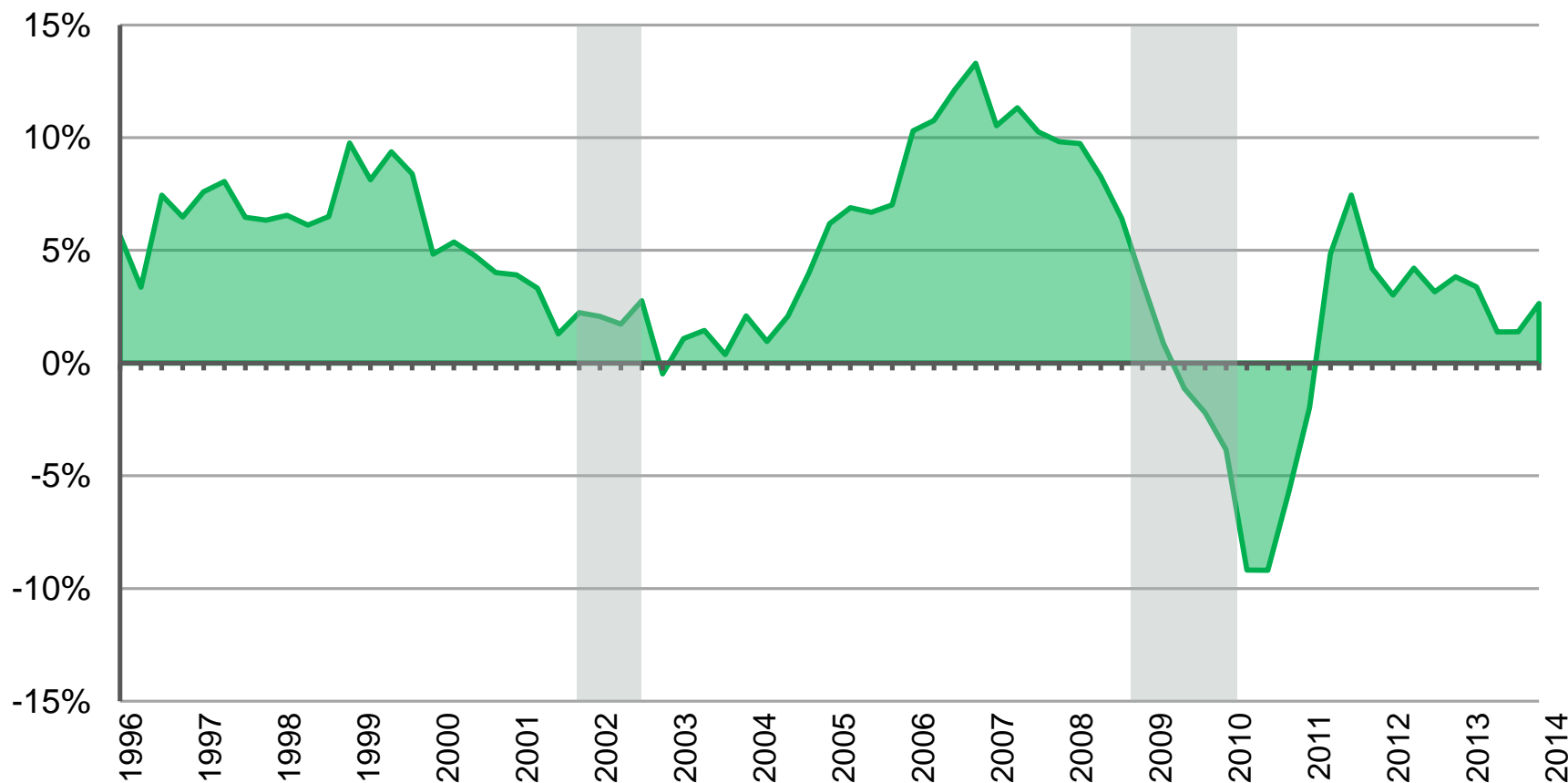
Best practices for depositing money into rainy day funds



Defining purpose and right-sizing rainy day funds

Revenue Fluctuations in North Carolina

North Carolina Tax Collections, 1995-2014, Year-Over-Year Growth



Source: Pew Analysis of state tax collections, Rockefeller Institute of Government, SUNY, Albany, N.Y.

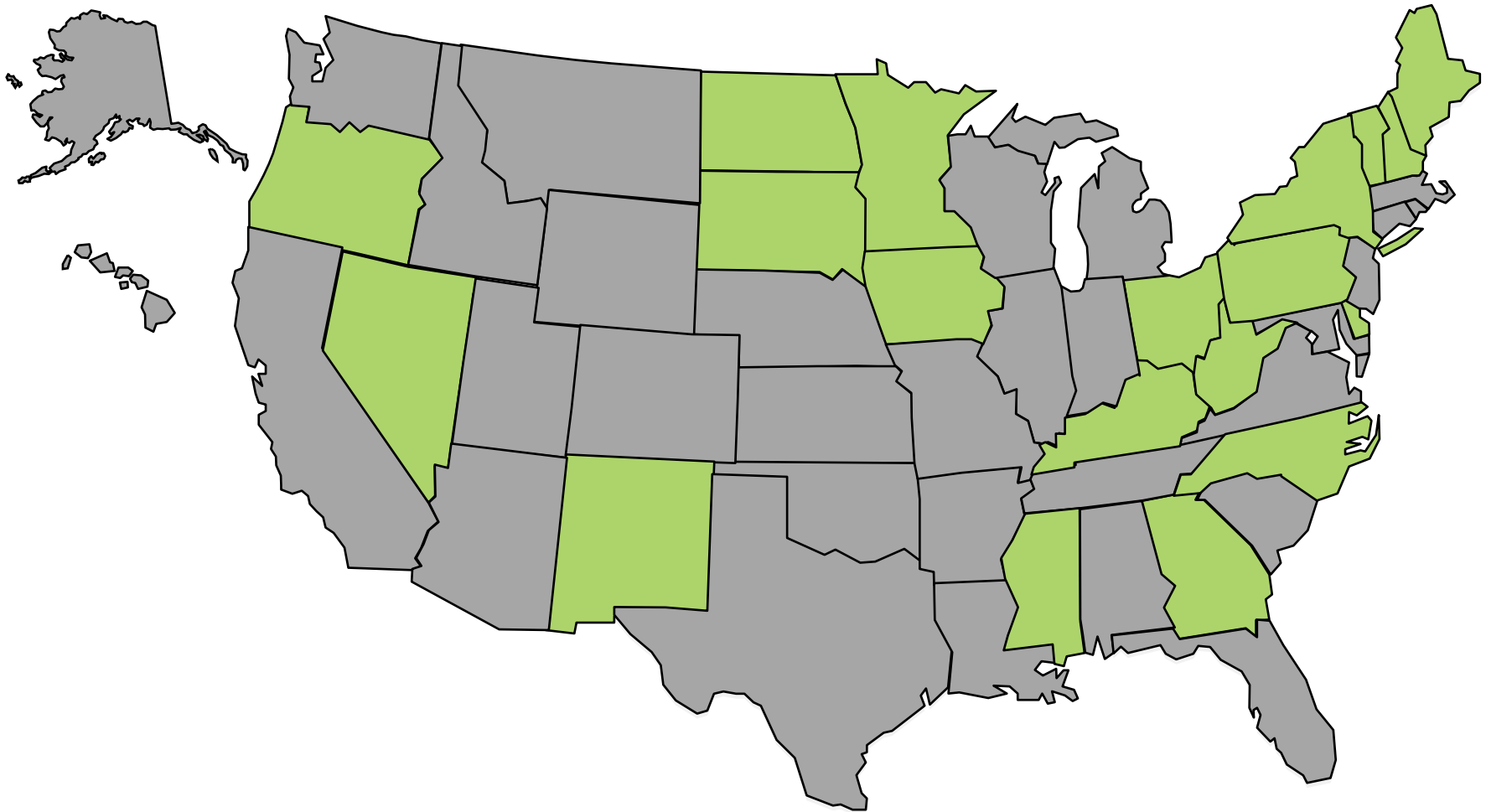
Why Does Volatility Matter?

- Influences **timing** and **size** of state budget surpluses and shortfalls
- Unpredictability confounds best efforts to craft and execute balanced budgets
- Smoothing volatility across the business cycle can help create a structurally sustainable long-term budget



Saving Based on Surplus

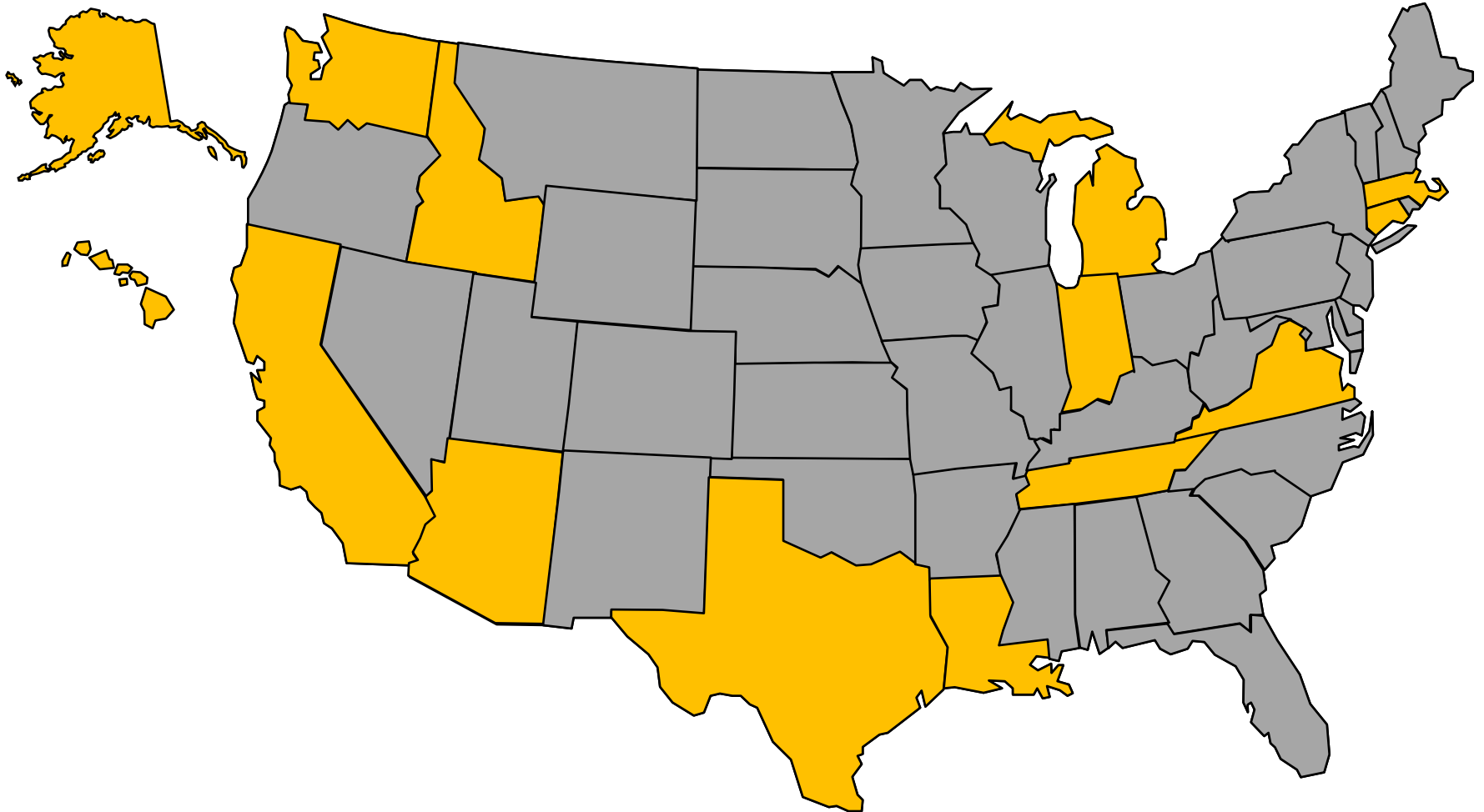
North Carolina is one of 19 states that saves based on how much money is left at end of fiscal year



The Problems with Depositing Based on Year-End Surplus

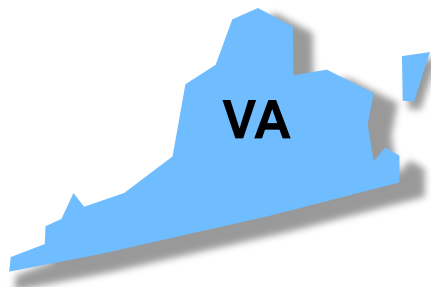


- **Makes saving a low priority**
- **Not necessarily tied to the business cycle**

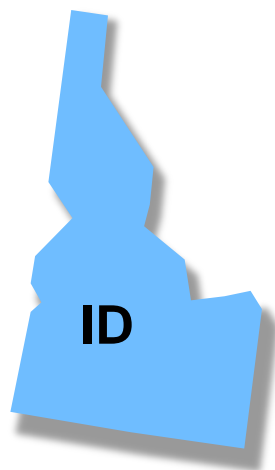


Harnessing Volatility for Rainy Day Funds

Some states link deposits to volatility in overall revenues



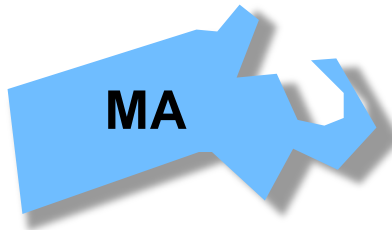
Deposits half of general revenue that exceeds the **six-year average growth rate**.



Deposits are made if general fund revenue **grows more than 4 percent**.
Deposits do not exceed 1 percent of annual revenues.

Harnessing Volatility for Rainy Day Funds

Some states link deposits to a single, volatile revenue stream



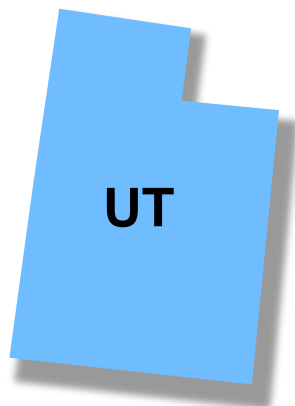
Massachusetts deposits **capital gains tax revenue** in excess of a threshold that grows with the economy.



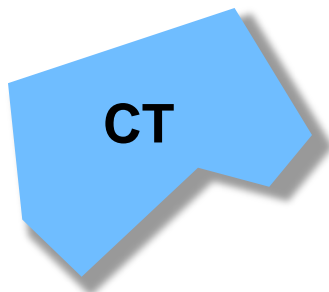
Texas deposits $\frac{3}{4}$ of **oil and gas severance tax revenue** above the benchmark revenue from 1987

Other Uses of Above-Trend Revenue

Some states link one-time revenues to other one-time priorities



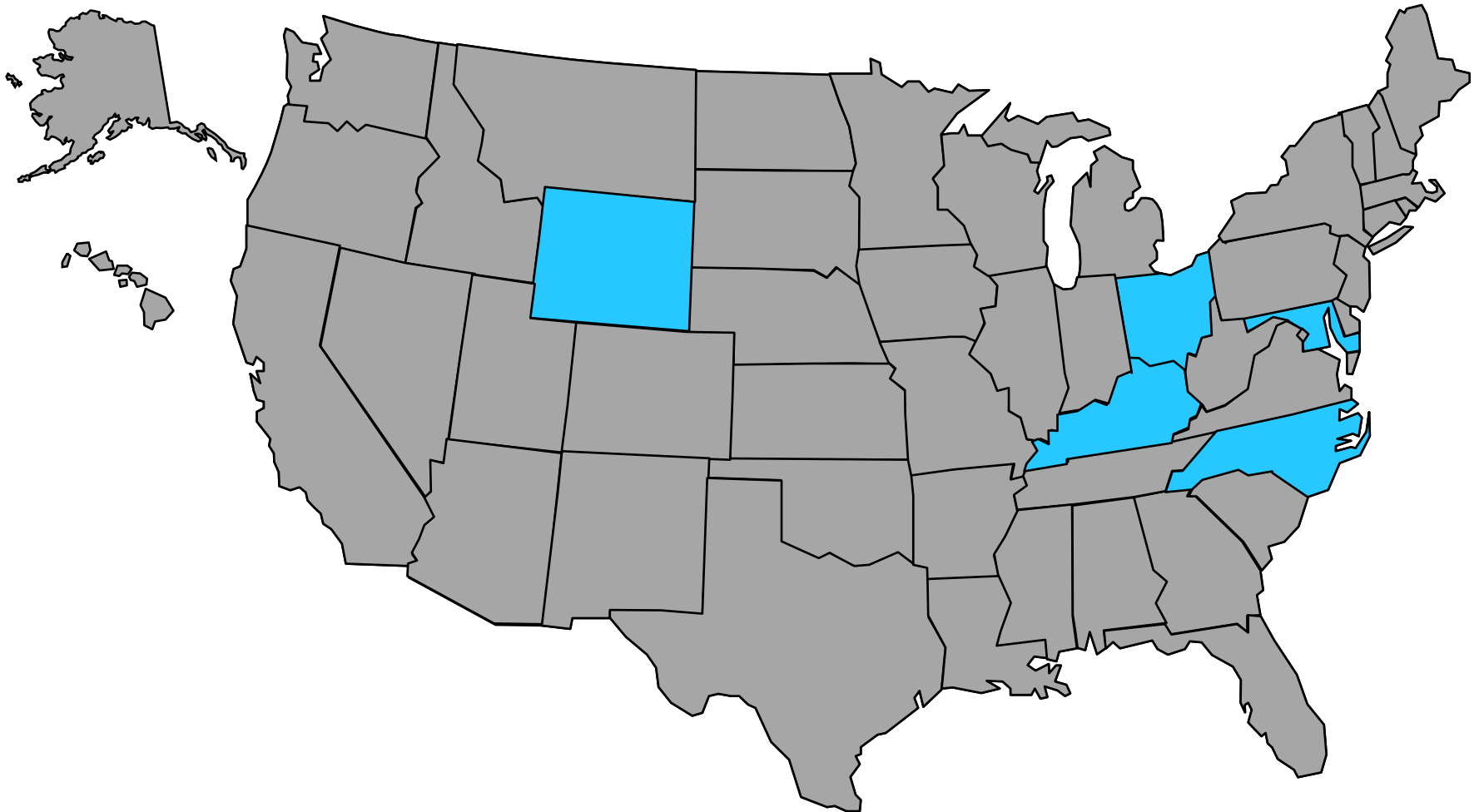
In 2015, legislators directed **above-trend general fund** revenue toward capital improvements.



Passed legislation to use some **above-trend capital gains and corporate income** taxes to pay down State Employee Retirement Fund's unfunded liabilities.

When to Use Rainy Day Funds

North Carolina is one of 5 states without withdrawal rules



Promising Practices for Withdrawal Rules



- Establish in law clear and objective conditions for withdrawal

- Base conditions on objective measures like revenue or economic volatility

- Use savings to fill one-time or temporary budget gaps, not gaps caused by structural budget issues

Rainy Day Fund Size

Is North Carolina's savings target of 8 percent of general fund revenues enough?



● Why are we saving?

● What is our desired level of coverage?

● How many years do we want to be covered for?

Minnesota Evaluated Why It Saves



Minnesota's Savings Target

- **Purpose:** Cover entire revenue shortfall during a recession
- **Length:** Two years
- **Risk:** Coverage for 9 out of 10 possible recessions



September 2015

Background

Like most state governments, Minnesota sets aside reserve funds to help manage budgetary uncertainty. Reserves afford policymakers greater financial flexibility during economic downturns and promote long-term fiscal stability. In addition, well-funded reserves are viewed positively by credit rating agencies.

Economists at Minnesota Management & Budget (MMB) and the University of Minnesota have developed a data-driven method for determining an appropriate reserve size given the prevailing degree of volatility in Minnesota's revenue system. This report summarizes MMB's findings from the most recent annual review.

Budget Reserve Recommendation

In accordance with Minnesota Statutes (M.S. 16A.152), MMB economists have reviewed the process used to model the volatility of Minnesota's general fund tax structure and determine the recommended size of the state's budget reserve. This evaluation updates the January 2015 report to reflect both an additional year of data and tax law changes enacted by the 2015 legislature.

To adequately manage the underlying risks in Minnesota's general fund tax revenue system, MMB recommends a budget reserve target of 4.8 percent¹ of the current biennium's general fund non-dedicated revenues, or a \$2.027 billion budget reserve for the 2016-17 biennium.² These conclusions assume the budget is structurally balanced through the remainder of the biennium, and policymakers desire a 95 percent level of confidence that a biennial deficit will not exceed budget reserves.³

Budget Reserve Report: September 2015

	Current \$ Level	% of FY 2016-17
		Non-Dedicated Revenues
MMB FY2016-17 Recommendation	\$2.027 billion ²	4.8%
Current Budget Reserve Account	\$994 million	2.4%
Difference	\$1.033 billion	

Note: The statutory reserve target is based on MMB's recommendation for the budget reserve account alone. The cash flow account is currently funded at \$350 million. Together, the budget reserve and cash flow accounts total \$1.344 billion, or 3.2% of FY 2016-17 non-dedicated revenues.

Rating Agency Top Scores Guideline (% of Biennial Revenues):

Standard & Poor's	≥4%
Moody's	≥5%

1. Rounded to the nearest tenth of a percent.

2. Based on End of 2015 Legislative Session General Fund Balance Analysis.

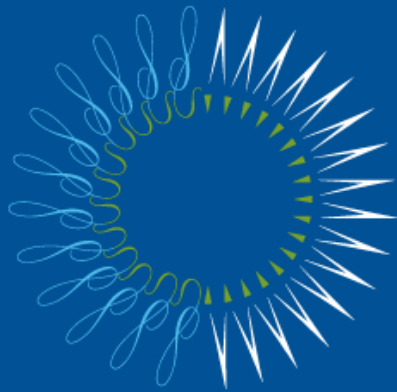
3. Changes made to the tax base or mix during the 2016 legislative session will be reflected in the September 2016 report.

BUDGET RESERVE REPORT

Steps to Improve the Savings Reserve Account



- Implement a volatility study to inform rainy day fund design
- Tie savings rule to volatility
- Establish withdrawal conditions



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Robert Zahradnik

rzahradnik@pewtrusts.org

pewstates.org/fiscal-health